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## **Real Corporate Governance Reform**

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Today marks the second anniversary of one of the most significant corporate governance reforms of all time. Sarbanes-Oxley? Nope. The real corporate governance reform of Bush's first term was the dividend tax cut that passed in May 2003. The dividend cut triggered an extended market rally, and launched a wave of favorable dividend activity that's now two years old and still going strong.

The 2003 Bush tax cuts accelerated tax write-offs for new capital investments, extended unemployment benefits, increased the child tax credit, and cut the rate on capital gains and dividend income to 15%. Political mayhem ensued as politicians and their rhetoric predictably assembled along party lines. Democrats immediately blasted the plan's alleged bias to the wealthy and decried its supposedly minimal impact on the overall economy. Republicans defended the bill's capacity to encourage investment and its resultant ability to produce job growth, new business starts, and higher government revenue.

Whether or not the Bush tax cuts drove the economic recovery, and the timing certainly suggests they did, one thing seems clear: the plan certainly has benefited investors---especially senior citizens who look to their retirement investments as a means for income.

Bush, like Ronald Reagan, considers growth in the stock market to be a critical sign of the economy's health and expectations of future growth. By slashing the tax on corporate dividends, Bush focused squarely on the task of forming new capital by raising shareholder value and boosting the stock market. The result: the Dow has jumped about 2000 points, or 22%, over the past two years, and the tech-heavy NASDAQ has gained more than 35%. And the tax cuts did more than breathe life back into stock markets--fast economic growth has also driven a boost in government revenue and lower deficits.

Although the Tax Reform Act of 1986 simplified the code, it made a huge mistake by raising the capital gains tax rate to that of ordinary income. It also failed to take the most important step of all---abolishing the double taxation of dividends. So, with an average 35% tax on corporate income *combined* with personal income tax rates as high as 38.6%, the effective tax rate on corporate profits to an investor was as much as 60%. Even an ordinary taxpayer paid a higher tax rate on corporate dividends than high-income taxpayers pay on their earnings. In practice, the high double tax on dividends encourages companies to hoard cash and make investments in the business rather than paying out dividends to investors. By mitigating this immense tax burden on dividends, the 2003 law triggered a wave of dividend hikes and initiations.

A recent study by the Cato Institute found that in the first year after the tax cut, dividends increased by an aggregate of over \$60 billion, and a 25 year decline in S&P 500 companies paying dividends was sharply reversed. More recent data from the American Shareholders Association shows that, for the first time since the 1980s, the number of companies paying a dividend increased for three consecutive years. ASA also finds that personal dividend income has increased by \$100 billion since the tax cuts. But ASA's most significant finding is that, for the first time in decades, earnings growth is correlated with dividend growth.

All of this is good news for those interested in improving corporate governance. The dividend tax cut has encouraged companies to stick to what they know and pay out earnings. Steady, profitable companies with large cash hoards finally have an incentive to pay out earnings in the form of dividends. With the reduction of the dividend tax, shareholders have been applying pressure on management to do so. Microsoft has already paid out the largest dividend in history to distribute much of its cash horde, and has also initiated annual dividends. Likewise, companies are now less likely to use their cash to venture into new fields---which may not be their core competency. Of course, this brings to mind many examples such as AT&T deciding to compete with Big Blue. As we know now---and investors learned via their wallet---this telephone giant of yesterday was not cut out to take on Michael Dell.

Steve Galbraith, Morgan Stanley's Chief U.S. Investment Officer describes the current market as a "back-to-basics" stock market. In the midst of uncertainty and concerns over accounting practices, investors demand sustainable and visible earnings from companies. Mr. Galbraith says, "The implications of such an environment are profound: Dividends and yields matter again." What does this all mean? Companies can fake their earnings reports, but they can't fake cold hard cash.

Dividends impose greater discipline on companies to focus on earnings. Because the tax cut leveled the playing field between short-term capital appreciation and dividend income, investors now have less incentive to avoid mature, dividend-paying companies and speculate on more risky stocks. Companies that do pay dividends have enjoyed a stock price boost, forcing companies that do not pay dividends to deliver earnings in order to win back investors.

Unfortunately, the dividend and capital gains tax cuts are set to expire at the end of 2008. If that happens, punitive rates of double taxation on dividends will return, dividend activity will diminish substantially, and we'll return to black-box earnings, cash hoarding, and corporate adventurism at stockholder expense. Congress should prevent even the threat of this happening by immediately making the 2003 tax cuts permanent. In fact, given the stunning success of the current law, President Bush should call on Congress to take the next step and completely eliminate the double taxation of dividends.

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